

**How to Assess High Quality Financial Reporting? –
An Analysis of Earnings Quality Metrics**

Research Proposal

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by

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Executive Summary

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The issue of our research project is the question how to assess the decision usefulness of financial statements in terms of “earnings quality” (EQ). Better knowledge of the determining factors of EQ and the properties of commonly used metrics of EQ helps standard setters in the evaluation of accounting standards both in the stage of developing standards and ex post evaluating standards. This research directly addresses the current debate on the methodology and process of post-implementation reviews of accounting standards at the IASB and other institutions.

Our research concentrates on conceptual issues of measuring earnings quality and is based on an analytical model. The purpose of this model is to develop a theory of EQ and to analyze the relationship between various metrics that are used in the empirical literature to measure the degree of EQ. Using the framework of a capital market with asymmetric information and rational expectations, we develop a model that captures various managerial incentives (which are commonly observed in practice) to influence earnings reports. We define EQ in terms of decision usefulness closely in line with the IASB’s Conceptual Framework and show how EQ is affected by a variation of managerial incentives and parameters representing the consequences of accounting standards and regulatory actions. In addition, we demonstrate how metrics commonly used in the empirical literature (value relevance, smoothness, persistence, predictability, discretionary accruals) are affected by changes in these parameters, how they are related to each other and, in particular, how they are related to EQ. These results help to assess the usefulness of empirical metrics to measure the degree of EQ and/or the impact of accounting standards on EQ in a specific context. The results can be found in the latest version of the paper “*Earnings Quality Metrics and What They Measure*” (available at SSRN under: <http://ssrn.com/abstract=1697042>).